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NO. 83-_____

IN THE

Supreme Court of the United States

OCTOBER TERM, 1983

THE TEXSTAR CORPORATION, Transferee Of The Assets Of Unitex Industries, Inc. And Its Subsidiaries,
Petitioner,

v.

UNITED STATES OF AMERICA,
Respondent.

PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE FIFTH CIRCUIT

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QUESTION PRESENTED

Original issue discount arises and a taxpayer is entitled to amortize the discount for federal income tax purposes if the taxpayer issues its debentures for its own preferred stock and incurs, "as a result of the transaction, some cost or expense of acquiring the use of capital." *Commissioner of Internal Revenue v. National Alfalfa Dehydrating and Milling Co.*, 417 U.S. 134, 147 (1974). The original issue discount is measured by the difference between the debenture's face amount (redemption value) and its fair market value on the date issued (issue price). *Id.* at 143. The question presented for review is whether the issue price of the debentures can be determined when the debentures exchanged do not have published market prices, but they are exchanged for the preferred stock after arm's length negotiations and the value of the preferred stock is established using the criteria set forth by this Court in *National Alfalfa*.

LIST OF INTERESTED PARTIES

Petitioner, The Texstar Corporation, was the transferee of the assets of Unitex Industries, Inc. ("Unitex"), a Texas corporation, which through its subsidiaries carried on various commercial enterprises. The Texstar Corporation and its wholly owned subsidiaries, through various reorganizations and liquidations, are now wholly owned second tier subsidiaries of The Hillman Company.

Respondent is the United States of America.

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UNITED STATES OF AMERICA,
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PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE FIFTH CIRCUIT

The Texstar Corporation petitions for a writ of certiorari to review the judgment of the United States Court of Appeals for the Fifth Circuit in this case.

OPINIONS BELOW

The opinion of the United States Court of Appeals for the Fifth Circuit is annexed hereto as Appendix A ("App. A") and is reported at 688 F.2d 362. The opinion of the United States District Court for the Northern District of

Texas is annexed hereto as Appendix B ("App. B") and is reported at 528 F.Supp. 75.

JURISDICTION

The judgment of the Court of Appeals was entered on October 7, 1982, and is annexed hereto as Appendix C. A timely Petition For Panel Rehearing was denied on November 4, 1982. See Appendix D. The jurisdiction of this Court is invoked under 28 U.S.C. § 1254(1).

STATUTES AND REGULATIONS INVOLVED

The statutory provisions and regulations involved in this case are as follows: The Tax Reform Act of 1969, § 413(e), Pub. L. No. 91-172, 83 Stat. 487 (1970); I.R.C. § 163(a), 26 U.S.C. § 163(a) (1978); I.R.C. § 1232(b)(2), 26 U.S.C. § 1232(b)(2) (1982); Treas. Reg. § 1.163-3(a)(1) (1968), T.D. 6984, 1969-1 C.B. 38, 26 C.F.R. § 163-3(a)(1) (1982); Treas. Reg. § 1.1001-1(a) (1971), T.D. 7142, 1971-2 C.B. 295, 26 C.F.R. § 1.1001-1(a) (1982); Treas. Reg. 1.1232-3(b)(2)(iii) (1972), T.D. 7213, 1972-2 C.B. 482, 26 C.F.R. § 1232-3(b)(2)(iii) (1982); and Treas. Reg. § 20.2031-2(f) (1958), T.D. 6296, 1958-2 C.B. 432, 480, 26 C.F.R. § 20.2031-2(f) (1982). These provisions are set forth in Appendix E.

STATEMENT OF THE CASE[1]

Petitioner's action for a refund of erroneously assessed federal income taxes and interest thereon is based on the

1. The operative facts are uncontested and are fully and fairly set forth in the District Court Opinion.

denial of an income tax deduction under I.R.C. § 163(a), *supra*, for amortizable debt discount. The basis for District Court jurisdiction was therefor 28 U.S.C. § 1346(a)(1). The amortizable debt discount arose when Unitex exchanged $2.00 cash and a $10.00 face amount debenture for each share of its outstanding preferred stock. The preferred stock and debentures were dissimilar in several respects. The redemption values were different. The dividend and interest rates were different, and, unlike the preferred stock, the debentures were subject to a sinking fund.

The exchange was precipitated by a corporate rehabilitation program initiated by new management in 1956. During Unitex's early history, it incurred losses resulting in a deficit in earned surplus. New management decided to eliminate the preferred stock because the accumulated deficit in earned surplus was making it difficult for Unitex to acquire additional financing. Elimination of the preferred stock would permit the recapitalization of Unitex common stock and thereby eliminate the deficit in earnings and profits. In pursuance of this objective, management proposed to the preferred stockholders an exchange of three (3) shares of common stock for each share of preferred stock. The proposal was rejected, unlike the proposed recapitalization in *National Alfalfa* which was approved "in due course". 417 U.S. at 139. A stockholder resolution was then passed directing the formulation of a plan to restructure the capitalization of Unitex in a manner satisfactory to protective committees formed for each of the common and preferred stockholder groups. Officers of Unitex and Dr. Bill Zentz, a professor of economics at Southern Methodist University and also economic advisor to the First National Bank in Dallas, Texas, re-

ported to the stockholders at their respective protective committee meetings on the financial condition of the corporation, the prices at which their stocks were trading and the prospects for future income on their investment. With this information in hand, the protective committees negotiated for over two years, rejecting numerous proposals and counterproposals, before the above described exchange was agreed upon.

The United States initially characterized the exchange as nothing more than a sophisticated adjustment of Unitex's capital accounts. It further contended the intent of the parties controlled and that neither Unitex nor its stockholders anticipated or agreed to original issue discount on the exchange.[2] Finally, the Government contended no original issue discount was created because Unitex acquired no new capital. Subsequent to the trial of this case the Government's contentions were rendered meritless by this Court's decision in *National Alfalfa*. *National Alfalfa* set forth the guidelines for determining whether debt discount arises when a corporation issues debentures in exchange for its own preferred stock. The controlling test is whether some cost of acquiring the use of capital occurs. 417 U.S. at 147. Once this base upon which debt discount can arise is established, the amount of discount is measured by the difference between the face and fair market values of the debentures issued. 417 U.S. at 143. The United States then argued Texstar did not establish the issue price of Unitex debentures at the time of the exchange.

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2. The jury found there was no *agreement* concerning discount. The jury did not find, as stated by the Fifth Circuit, that Unitex did not incur a cost deductible as bond discount. App. A at 5a.

Relying on *National Alfalfa* and *Gulf, Mobile & Ohio R.R. v. United States*, 579 F.2d 892 (5th Cir. 1978) (*"G M & O"*), the District Court determined Petitioner had established the base upon which debt discount could arise; that Unitex incurred as a result of its recapitalization a substantial cost for the use of capital. App. B at 21a. As in *G M & O*, and unlike *National Alfalfa*, the capital on the books of Unitex representing each outstanding share of preferred stock, $8.11, was less than the total of the face amount of the debenture and cash, $12.00, exchanged for such share. Unitex also incurred the additional cost of establishing a sinking fund for the retirement of its debentures which was not a characteristic of its outstanding preferred stock. Neither the United States nor the Fifth Circuit challenged Unitex's satisfaction of the additional cost requirement.[3]

Relying on the valuation evidence presented at the trial and this Court's comparison of *Southern Fertilizer & Chemical Co. v. Edwards*, 167 F.Supp. 879 (M.D. Ga. 1955) with the intracorporate exchange in *National Alfalfa*, 417 U.S. at 151, the District Court determined Petitioner had established the issue price of the Unitex debentures. App. B at 23a. At the trial, Petitioner's expert witness testified that he considered four valuation methods in reaching his conclusion that each share of Unitex preferred stock had a fair market value of $3.99 on December 31, 1959, the date of the exchange. In determining the investment value of Unitex stock, $3.99, the expert considered Unitex's financial condition at the time of the exchange, including both its credit position and its profits prospects and the availability and cost of

3. Footnote 11 discusses what may be a challenge to the establishment of a cost by the Fifth Circuit.

capital in the general market as well as from its preferred stockholders. Of particular importance, he compared the likely return on the preferred stockholders' investment in Unitex with what they would receive in the bond market. The expert's credentials and experience in the field of valuing corporate securities were substantial. His qualification to serve as an expert witness was unchallenged. His testimony was uncontradicted and both a jury and the District Court found the value of Unitex preferred stock to be $3.99 per share at the time of the exchange.[4] In *Southern Fertilizer*, an exchange which occurred after unlisted securities were exchanged following two years of stockholder negotiations, the District Court determined the parties were dealing at arm's length, the items exchanged were of equivalent value and the debentures were issued at a discount. 167 F.Supp. at 881. Since Unitex stockholder protective committees negotiated the terms of the exchange at arm's length for two years, just as in *Southern Fertilizer*, the District Court equated the value of Unitex preferred stock, $3.99, with the $2.00 cash and debenture received in exchange to arrive at an issue price for the debentures of $1.99. The resultant discount, the face amount less issue price, was therefore $8.01 per debenture.[5] App. B at 23a.

The Court of Appeals for the Fifth Circuit reversed the District Court. It held Petitioner did not establish the issue

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4. The Honorable Leo Brewster impanelled an advisory jury.

5. The District Court reached this figure as indicated, and not by subtracting the value of the preferred stock from the face amount of the bond. App. A at 5a. The Fifth Circuit is clearly mistaken on this point. See footnote 11 for further evidence of the failure to distinguish between incurring the requisite cost for debt discount and measurement of the discount.

price of Unitex debentures because neither the debentures nor the preferred stock were actively traded. It concluded that, without active trading, published market prices were not available in the *Wall Street Journal*. Without published market prices, neither the presence nor the calculation of debt discount could be justified by the Court. App. A at 11a. It further held the exchange was insulated from market forces, as in *National Alfalfa*, thereby negating an equivalence in value of Unitex preferred stock and Unitex debentures (plus cash).[6] App. A at 10a.

REASONS FOR GRANTING THE WRIT

I. The Decision Below Conflicts With The Decision Of This Court, The Decisions Of All Other Courts Of Appeals And Internal Revenue Service Regulations Which Permit The Use Of Expert Testimony To Determine The Value Of Securities Exchanged In A Recapitalization.

The decision below stands alone and is in direct conflict with the decision of this Court in *National Alfalfa* concerning the means for valuing securities, which is the prerequisite to measuring debt discount. Indeed, the Fifth Circuit acknowledged that the valuation testimony in this case included those factors which this Court in *National Alfalfa* "suggested were essential to a determination of the value of untraded debentures." App. A at 10a, footnote

6. Approximately two-thirds of the G M & O stockholders elected to exchange their stock for bonds. App. A at 7a. That one-third of the stockholders did not exchange did not dilute an equivalence in values of G M & O securities, yet the Fifth Circuit found it did in this case. App. A at 11a, in footnote 5.

"it is for the district court to determine what is the best available market assessment of the value of the debentures at issuance. As indicated in *National Alfalfa*, where there is no available market evaluation, the district court's inquiry might include consideration of the taxpayers 'financial condition at the time of the exchange including both its credit position and its profits prospects, and the availability and cost of capital in the general market as well as from its preferred shareholders.' ____ U.S. at ____, 42 U.S.L.W. at 4803." 522 F.2d at 1291. In *Fed-Mart Corp.* the District Court received expert testimony as to the market value of the bonds exchanged and devoted a substantial portion of its opinion thereto. Giving due regard to "the opportunity of the trial court to judge the credibility of the witnesses", and without rejecting the applicability of expert testimony, the Ninth Circuit appropriately affirmed the District Court because its factual findings were not clearly erroneous. 572 F.2d at 238. Further, a case preceding *National Alfalfa, Atchison, Topeka & Santa Fe R.R. v. United States*, 443 F.2d 147 (10th Cir. 1971), was a bonds-for-bonds exchange in which the issue price of the bonds was established by evidence from experts.

Absent a specific statutory exception, the Internal Revenue Service has consistently held that the fair market value of property is a question of fact and only in rare and extraordinary cases will property be considered to have no ascertainable market value. Treas. Reg. § 1.1001-1(a), *supra*. That published market prices are generally not needed for valuation purposes is further supported by the regulations under I.R.C. § 1232(b)(2), *supra*, a specific statutory exception applicable to the issue price

of bonds issued after May 27, 1969.[7] The "published market prices" requirement contained in the 1969 amendment to I.R.C. § 1232(b)(2), *supra*, is made specifically inapplicable to obligations issued on or before May 27, 1969. *The Tax Reform Act of 1969*, § 413(e), *supra;* Treas. Reg. § 1.1232-3(b)(2)(iii)(e), *supra*. Unitex debentures were issued on December 31, 1959.

Even the United States, against its own interest, stated on page 5 of its Reply Brief filed below: "[w]e do not argue that the bonds and preferred shares must be traded on a national exchange before bond discount can arise, . . ." In the absence of a "published market prices" limitation, the Fifth Circuit's reversal of the District Court's factual findings exceeded the proper scope of its review, since such findings were not clearly erroneous. *United States v. United States Gypsum Co.*, 333 U.S. 364 (1948); Pullman-Standard v. Swint, ____U.S.____, 102 S.Ct. 1781 (1982). By adopting such a limitation on original issue discounts, the Fifth Circuit's holding is in conflict with all prior precedent and should be reversed.

II. The Decision Below Conflicts With The Decisions Of This Court And Various Courts Of Appeals Which Have Found Arm's Length Exchanges Sufficient To Establish An Equivalence In Value Of The Items Exchanged.

Upon ample uncontradicted evidence, the District Court considered the subject exchange to be a voluntary free market transaction. App. B at 21a. For this reason, the

7. § 1232 sets forth the income tax consequences to the holder of obligations as opposed to the issuer. See footnote 9 for the legislative history behind the adoption of a "published market prices" limitation.

District Court properly assumed an equivalence in value of the items exchanged. The Court of Appeals for the Fifth Circuit held that the District Court erred in equating the value of Unitex preferred stock with the value of Unitex debentures because the transaction had been "insulated from the marketplace" as in *National Alfalfa*. App. A at 11a.

The Fifth Circuit was wrong in equating the exchange in issue with the intracorporate exchange involved in *National Alfalfa*. National Alfalfa Dehydrating and Milling Co.'s preferred stock was redeemed pursuant to a plan structured by the board of directors without stockholder input or negotiations. Its stock was redeemable at the discretion of the board of directors; the preferred stockholders were in no position to negotiate. In complete contrast to *National Alfalfa*, the preferred stock now in issue was exchanged only after two-thirds of both the common and preferred stockholders agreed to a plan which protective committees had structured after two years of meetings, bargaining and negotiations. The resulting exchange of debentures for outstanding preferred stock was not an intracorporate exchange insulated from market forces. It was an exchange identical in all material respects with the *Southern Fertilizer* exchange discussed earlier and cited by this Court in *National Alfalfa* as a free market exchange. 417 U.S. at 151. The decision below is therefore in direct conflict with *National Alfalfa* and with this Court's decision in *United States v. Davis*, 370 U.S. 65 (1962). *Davis* involved the valuation of marital rights exchanged for marital property, including securities. This Court held that the taxable gain realized by the husband under these circumstances could be determined by equating the values of the properties exchanged, stating: "Ab-

sent a readily ascertainable value it is accepted practice where property is exchanged to hold . . . that the values 'of the two properties exchanged in an arms-length transaction are either equal in fact or are presumed to be equal'." 370 U.S. at 72, citing *Philadelphia Park Amusement Co. v. United States*, 130 Ct. Cl. 166, 172, 126 F.Supp. 184, 189 (1954). Obviously the marital rights involved in *Davis* did not have published market prices. This did not affect or alter the "accepted practice" of equating the values of the properties which had been exchanged at arm's length.

The Fifth Circuit's decision also is in conflict with substantial precedent established by various Courts of Appeals and the United States Court of Claims. *See, e.g., Southern Natural Gas Co. v. United States*, 412 F.2d 1222 (Ct. Cl. 1969) (value of stock established by value of materials and services for which it was exchanged); *Tasty Baking Co. v. United States*, 393 F.2d 992, 993-95 (Ct. Cl. 1968) (value of employees' services determined by value of property contributed to employee pension trust); *A.P. Smith Manufacturing Co. v. United States*, 364 F.2d 831 (Ct. Cl. 1966), *cert. denied*, 385 U.S. 1003 (1967) (contribution of stock to employees' retirement trust); *United States v. General Shoe Corp.*, 282 F.2d 9, 11-13 (6th Cir. 1960), *cert. denied*, 365 U.S. 843 (1961) (contribution to retirement trust); *International Freighting Corporation, Inc. v. Commissioner of Internal Revenue*, 135 F.2d 310, 313 (2d Cir. 1943) (distribution of stock bonus). *See also, Atchison, Topeka & Santa Fe R.R. v. United States, supra*, (negotiations between interested groups of security holders conducted at arm's length gave rise to amortizable bond discount). None of these decisions involved negotiations or exchanges

more clearly conducted at arm's length than the exchange in this case. Yet in each case, the equivalence of the values of the exchanged properties or rights was established by the evidence. The Fifth Circuit's decision below is in direct conflict with these authorities and should be reversed.

III. The Decision Below Capriciously Discriminates Against Small And Closely Held Corporations.

It has long been the law that tax deductions are a matter of legislative grace and that Congress may discriminate between certain classes of taxpayers. *New Colonial Ice Co. v. Helvering*, 292 U.S. 435, 440 (1934). Nevertheless, deductions granted by Congress cannot be capriciously denied those persons or entities intended to be benefited. *Heiner v. Donnan*, 285 U.S. 312 (1932); *Allied Stores of Ohio, Inc. v. Bowers*, 358 U.S. 522, 527 (1959); *Welch v. Henry*, 305 U.S. 134, 145 (1938); *Barclay & Co., Inc. v. Edwards*, 267 U.S. 442, 450 (1925). Successive Treasury Regulations, beginning with Art. 150 of Treasury Regulations 33 (revised 1918), issued under the Revenue Act of 1916, through and including current Treas. Reg. 1.163-3(a)(1), *supra*, have recognized debt discount as an additional cost incurred in borrowing money, and have granted the issuers of obligations an income tax deduction for same. It was not until 1969, when Congress became aware of the "whipsaw" problem[8] created by its amendment of I.R.C.

8. Prior to 1969, issuers of obligations were allowed a deduction each year with respect to debt discount. The holder was not required to report income until he disposed of the obligation. § 1232 was amended to provide that the holder and issuer be treated in a consistent manner. With this amendment the "whipsaw" problem arose, i.e., the issuer claiming a low value for property received in order

§ 1232(b)(2), *supra*, that a "published market prices" limitation was adopted. The amendment, its legislative history and the regulations thereunder, make two points abundantly clear. First, Congress was concerned with the whipsaw problem and not the task or valuing unlisted or thinly traded securities.[9] The Internal Revenue Service and courts had many years of experience with the valuation of securities and guidelines had been established for such purposes in Treasury Regulations, Revenue Rulings and court decisions too numerous to cite. Treas. Reg. § 20.2031-2(f); Rev. Rul. 59-60, 1959-1 C.B. 237. The value of a security and whether that security's value may be determined in a specified manner so as to qualify for certain benefits are totally unrelated issues. Second, Congress chose not to make the new requirement retroactive. *The Tax Reform Act of 1969*, § 413(e), *supra*. Had the Fifth Circuit's adoption of the "published market prices" limitation been addressed to some existing inequity, an argument against capriciousness could be made. But to address a "published market prices" limitation, prior to its effective date, to an unrelated issue, i.e., the actual valuation of securities without published market prices,

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to obtain a bond discount amortization deduction, and the holder claiming a high value for the property paid in order to avoid original issue discount income. This was a problem because it was not possible to bring both parties together in the same lawsuit or otherwise insure consistent valuations.

9. In the bill which was approved by the House and by the Senate Finance Committee, section 1232(b)(2), which defines issue price, did not have the "published market prices" limitation. H. Rept. No. 91-413 (1969), 1969-3 C.B. 200, 269; S. Rept. No. 91-552 (1969), 1969-3 C.B. 423, 517. The bill was then amended to include the "published market prices" limitation after it was before the entire Senate and a letter from a Treasury official describing the "whipsaw" problem was read and made a part of the record. Conf. Rept. No. 91-782 (1969), 1969-3 C.B. 644, 662.

in the face of overwhelming conflicting authority, including this Court's guidelines set forth in *National Alfalfa*, truly amounts to a usurpation of the legislative function and the capricious deprivation of Congressionally granted benefits, without prior notice, to the vast majority of corporations which are either too small or too closely held to have published market prices for their securities.

CONCLUSION

Due to the *Tax Reform Act of 1969* and *National Alfalfa*, as unanimously construed by the Courts of Appeals deciding pre-1969 original issue discount cases, Petitioner felt this case was of no precedential value. The decision below, however, by adopting an unprecedented extremely restricted means of valuing securities, and by limiting the markets (only published markets) in which informed persons dealing at arm's length can intelligently value the items they are exchanging, will have enormous impact in two principal areas. First, corporate bonds and debentures are typically outstanding for twenty to thirty years. The new "published market prices" limitation became applicable only thirteen years ago. Statistics obtained from the New York Stock Exchange indicate that in excess of 99% of the corporations do not have published market prices for their securities.[10] Therefore, in reliance on the Fifth Circuit's opinion, the Internal Revenue Service will be in a position to challenge the undoubtedly numerous continuing amortization deductions by unlisted corporations which issued their bonds or debentures in exchange for property other than listed securities or cash.

10. Only 1,526 corporations are listed on the New York Stock Exchange, but there are 344,624 for profit corporations authorized to do business in Texas alone.

Second, the Fifth Circuit's decision may well have unpredictable and unforeseeable effects on the general application of valuation principles in all types of tax cases.[11] To Petitioner's knowledge, never before has a court stated market conditions do not exist and that values cannot be determined by persons negotiating at arm's length if they do not have access to published market prices. Until the decision below, the courts have uniformly relied on a company's net worth, prospective earning power, market conditions and other relevant factors in determining the fair market value of unlisted securities. They have also equated the values of property exchanged at arm's length. This Court should resolve the conflict that has now arisen regarding these fundamental valuation principles so integral to the administration of our already too complex

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11. The obvious inconsistencies and erroneous factual assumptions in the decision below disclose its failure to adequately deal with the complexities of this case. For example, a cost was found to exist in *G M & O* because the original value received for the preferred stock was less than the face amount of the bonds. App. A at 8a. Yet the Fifth Circuit found little merit in Petitioner's identical argument. App. A at 12a, footnote 6. The same inconsistency is found with respect to the costs of sinking founds. App. A at 8a and at footnote 6. After a cost is established as described above, the discount is measured by subtracting the issue price of a debenture from its redemption value. Footnote 6 of the decision below further discloses its total confusion concerning this simple two-step process by stating "In determining the amount of bond discount, this Court in *G M & O* relied upon the value of the preferred shares at the time the bonds were issued, not the original value received for the stock." A failure to rectify the Fifth Circuit's errors can only lead to confusion in the administration of our already complex tax laws.

tax laws. The petition for a writ of certiorari should be granted.

Respectfully submitted,

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